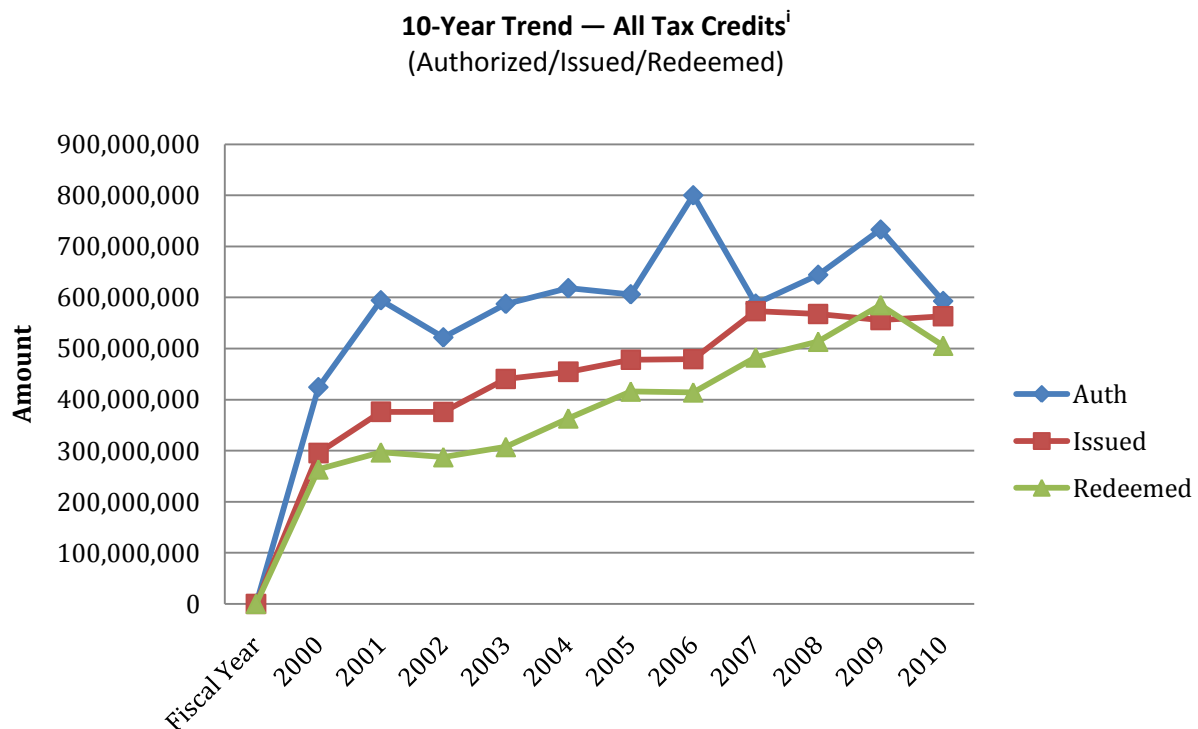


## The Negative Effects of Targeted Development Tax Credits in Missouri

By Christine Harbin, Research Analyst, Show-Me Institute

The state government in Missouri has issued \$3,478,108,538 in targeted tax credits since 2000. Meanwhile, there is much evidence that this expenditure doesn't encourage economic activity and job growth.

In this white paper, I explain how targeted tax credits programs in Missouri are a significant problem that negatively affects Missouri's economy. I will refer to research demonstrating that, in Missouri and in other states, these programs are a poor strategy for economic development. I will indicate the significance of this problem, and conclude with proposed solutions and actions to address it.



## SIGNIFICANCE

From fiscal year 2001 to fiscal year 2009, tax credit redemptions in the state of Missouri increased by 57 percent, while net general revenue (GR) fund collections by the state increased by only 15.7 percent.<sup>ii</sup>

Because the Missouri state government has to pay for these programs, it has already had to make cuts in education and public safety.<sup>iii</sup> Whenever the state of Missouri awards a tax credit, that credit comes at the expense of other activities. This is because the state has a budget, and a dollar spent on tax credits is a dollar that the state must cut from another program.

To exacerbate this problem, unredeemed tax credits represent a future financial liability for the state. This is because many credits do not have to be redeemed in the year that they were issued. The existence of such unredeemed credits negatively affects Missouri's ability to recover from difficult economic times, because officials will have to dole out money at unexpected intervals in the future.

When these tax credits are redeemed in the future, it could cause the state to run a deficit, or exacerbate an existing deficit. Even if Missouri were to scale back or eliminate its incentive programs, it could still end up paying out in the future as existing credits are redeemed. The uncertainty of when these tax credits will be redeemed makes it more difficult for policymakers to forecast and plan future budgets.

In their efforts to solve economic problems in their area, government officials are more likely to support projects that are large and easily observable instead of projects that are more likely to achieve genuine, long-term economic growth.<sup>iv</sup> Large development projects are easy to see, but the *unseen*<sup>v</sup> includes the jobs that were destroyed because the money that would have funded them was appropriated for other uses. A renovated historical building is an easily *seen* effect; however, the products and services that would have otherwise been consumed in the private sector, in the absence of that renovation, represent the *unseen* effects.

## CONCENTRATED BENEFITS, DIFFUSED COSTS

In subsidy programs, the state government redistributes wealth to special interest groups in the form of concentrated benefits, and it diffuses the costs of these benefits to all those who remain unsubsidized in the marketplace. In short, tax credits are a form of wealth redistribution — we all bear the cost, but only special interests and favored industries benefit.

Tax credits operate by reducing the individual or corporate income tax bills of credit recipients. By reducing the tax burden of a single targeted industry or company, the marginal tax rate for everybody else increases if overall government spending is not also reduced by the amount of that credit.<sup>vi</sup> In addition, the fact that many of these tax credits are transferable means that they can be sold on a secondary market. Consequently, tax credits can ultimately benefit individuals who have nothing to do with the rationale for their issuance.

Tax credits often don't create economic activity, but instead merely shift it to another location. When states compete over companies by offering increasingly generous incentive packages, taxpayers lose because they have to foot the bill. This dynamic also forces small businesses that lack lobbying power to compete at a competitive disadvantage. As a recent example, while Ford lobbied for \$150 million in tax incentives from Missouri, the company also courted Kentucky<sup>vii</sup>, Michigan<sup>ix</sup>, Ohio<sup>x</sup>, and Illinois<sup>xi</sup> for financial assistance, communicating the message that it would locate within the borders of the highest bidder.

## EXAGGERATED BENEFITS, UNDERSTATED COSTS

### Failures in Missouri

In practice, targeted tax credit programs defeat the purposes that supporters usually cite in their favor: encouraging employment and helping Missouri compete. In April 2010, the Missouri state auditor issued a report, "Findings in the audit of Tax Credit Cost Controls,"<sup>xii</sup> communicating that tax credits have less of an impact than predicted and cost more than anticipated. The auditor reviewed 15 major tax credit programs in Missouri and found that the fiscal notes underestimated the total cost of the programs by \$1.1 billion over a five-year period.<sup>xiii</sup> Additionally, the report remarked that the short time frame — three years — of the cost estimates limits their ability to predict long-term effects. The audit also notes that even longer estimates are inaccurate and unable to predict true costs.

The auditor issued a report in September 2010 echoing the conclusion that tax credits fail to deliver their predicted results. The report studied 19 businesses authorized for Enterprise Zone Tax Credits (EZTC) and Enhanced Enterprise Zone Tax Credits (EEZTC), and found that the actual jobs created

were 6.1 percent fewer than proposed in 2007, and actual investment was 29.5 percent less than proposed.<sup>xiv</sup>

As an example, data from the Bureau of Labor Statistics show that the film industry in Missouri hasn't experienced significant job growth as a consequence of film tax credits.<sup>xv</sup> In fact, the number of Missourians employed in the film industry has decreased.<sup>xvi</sup> Meanwhile, the Missouri state government spent approximately \$13 million over the last 10 years on this program. Despite the program having achieved the opposite of its intended objectives, there are nonetheless continued calls for its expansion.

## Failures in Other States

Policymakers often look to the economic development strategies used in other states and try to emulate them. In fact, tax credit programs have failed to deliver on their promises in other states, as well. The Mackinac Center for Public Policy in Michigan published an extensive survey and review of Michigan's tax credits<sup>xvii</sup> and found that only 7.9 percent of projects were completed on time and produced the number of jobs promised.<sup>xviii</sup>

Ohio has had a similarly unsuccessful experience with its targeted tax credit program. Approximately 1 in 10 jobs that officials promised would result from the credits were not created, according to a 2010 report by the *Columbus Dispatch*.<sup>xix</sup> The state government in Ohio had approved 955 projects using tax credits since 1993. Although it had originally forecasted \$1.6 billion in activity, only \$525 million, or 40 percent, in tax certificates had been issued during that period. Additionally, the study noted that, for several credits, the projected number of jobs was revised after submission. The projected jobs for one particular project was reduced from 3,323 to 491. Many other projects listed zero jobs committed.

## Shortcomings in Studies

Furthermore, these studies rely on the existence of a "multiplier effect" — the purported ability of government spending to incite resonating economic activity. However, the evidence suggests that tax credit programs have no magic multiplier or spillover effects.<sup>xx</sup> University of Missouri–Columbia economist Emek Basker found that there is a substitution in economic activity from all other industries to the ones receiving the tax credit.<sup>xxi</sup> This causes the state's tax base to shrink. To supply the same number of services, revenues must be made up by applying a larger tax rate to the remaining tax base.<sup>xxii</sup> Many audit reports have found inaccuracies and omissions in the data collection conducted by the Department of Economic Development (DED) regarding tax credit programs.<sup>xxiii</sup> In a recent example, a September 2010 audit by the state auditor's office found that the DED had a 43-percent error rate simply when *recording* estimated jobs and investment figures from businesses receiving EZTC. In one instance, the DED inflated a business' investment estimate by 1,438 percent.<sup>xxiv</sup>

## RECOMMENDATIONS FOR REFORM

### Elimination

My first proposal for reform is to eliminate targeted development tax credit programs in Missouri. From a fundamental and empirical perspective, tax credits are inferior to other economic development tools at the state government's disposal.

By offering tax credits that are targeted to specific industries and companies, the state is acknowledging that doing business in Missouri is prohibitively expensive. As a negative consequence of this policy, the state government places non-favored businesses at a comparative disadvantage, and

makes it even more difficult for them to compete. As a second negative consequence, it gives special interests the incentive to petition the government for special favors, when they could instead spend their efforts engaging in productive work.

In the game of picking winners and losers, the government almost always picks losers. This is because the government chooses to protect companies and industries that the market has already rejected to some degree. If they were successful and viable on their own, they wouldn't need to seek the favor of the government. A knowledge problem exists: When the government attempts to plan the economy, it asserts that it knows the optimal level of something. In practice, such a level is impossible to determine. I do not know the socially optimal mix of any set of products and services, and neither do government officials. No one has access to perfect information. It would be beneficial if the state government stayed out of playing favorites in the market and instead let individuals determine their own optimal levels by engaging in unrestricted trade.

Even if other nations, states, or localities offer tax incentives to lure businesses, Missouri would be better off if we don't do the same — because we benefit from the lower prices that those subsidies create, without it costing Missouri's taxpayers a dime. It would be better for everyone if all states stopped providing these subsidies, but Missouri will still experience better economic growth if it unilaterally removes itself from the tax incentive bidding wars.

Missourians would benefit if the state government took a hands-off approach to economic development instead of providing subsidies to private companies. Missouri's tax credit programs have not fulfilled their stated purposes, and spending more on them will not likely result in better outcomes. Missouri's tax dollars would be much better spent in the hands of individual Missourians than on enticements for particular companies.

Instead of using public dollars to attempt to pick winners and losers, the state government should let consumers and investors decide which businesses, developments, and films succeed.

## Improvements in Data Collection

Although the best-case scenario would be to eliminate all development tax credit programs, I realize that we live in a world of second-best solutions and that this may not be politically feasible. There are other policy changes that the state government can investigate, such as improving its data collection. The DED may take additional steps to ensure that its data is correct, for instance, with no inaccuracies or omissions.

When measuring the performance of tax credit programs in Missouri, policymakers should instead consider whether any jobs or economic activity have been generated by programs in progress, not the hoped-for activity from credits that were very recently authorized or issued. It is misleading to herald the number of *projected* jobs and *projected* economic activity as evidence for success, as the DED does now, or to rely on data that is self-reported by tax credit recipients.

As a positive consequence of refining the metrics by which success is gauged, the state government will have more information available to weed out tax credit fraud and application discrepancies.<sup>xxv</sup>

## Annual or Cumulative Limits, Sunset Provisions

Second, limits and sunset clauses should be used to control the cost of tax credits programs in Missouri, given that the fiscal notes had poor predictive power. This was proposed in the April 2010 report from the state auditor's office, which pointed out that, of the 53 programs redeemed in 2009, 23 did not have annual or cumulative limits. The report also observed that it is difficult to predict the long-term effects of specific tax credits; with a sunset provision, the effects are reviewed and evaluated

before a program is continued. Annual and cumulative limits would hold tax credits to the amount specified by the bill, which would discourage underestimates as well as control tax credit expenditures.

## NOTES

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<sup>i</sup> From the Department of Economic Development (DED) presentation on tax credits from the Missouri Tax Credit Review Commission, Sept. 2010.

<sup>ii</sup> "Findings in the audit of Tax Credit Cost Controls," Office of the State Auditor of Missouri, Susan Montee, 2010. Online here: [tinyurl.com/2fdkp7v](http://tinyurl.com/2fdkp7v)

<sup>iii</sup> Nixon, Jay. Opening remarks to the Tax Credit Review Commission. Sept. 8, 2010.

<sup>iv</sup> Dewar, Margaret, "Why State and Local Economic Development Programs Cause so Little Economic Development." *Economic Development Quarterly*, 1(12), 1998, pp. 68–87. Online here: [tinyurl.com/2e9r7ca](http://tinyurl.com/2e9r7ca)

<sup>v</sup> Hazlitt, Henry, *Economics In One Lesson*, The Foundation for Economic Education, 1952. Online here: [tinyurl.com/5y65vp](http://tinyurl.com/5y65vp)

<sup>vi</sup> Haslag, Joseph, Steve Bernstetter, and Michael Podgursky, "Centralized Economic Policy Bad for Missouri," June 14, 2007. Online here: [tinyurl.com/27zoyxt](http://tinyurl.com/27zoyxt)

<sup>vii</sup> Adams, Brent. "Ford gets more state incentives, will boost investments at Louisville plants," Oct. 30, 2008 Online here: [tinyurl.com/27oth8q](http://tinyurl.com/27oth8q)

<sup>viii</sup> Governor Fletcher Announces Incentive Package Approved For Ford Motor Company In Louisville. Kentucky Cabinet for Economic Development. June 28, 2007. Online here: [tinyurl.com/23r6tth](http://tinyurl.com/23r6tth).

<sup>ix</sup> Governor Granholm Announces 10,884 New and Retained Jobs for Michigan. Office of the Governor. June 15, 2010. Online here: [tinyurl.com/2ey7bgu](http://tinyurl.com/2ey7bgu)

<sup>x</sup> Lyne, Jack. "Ford, Ohio at Odds over \$83M Incentive Package." Site Selection. Online here: [tinyurl.com/276964f](http://tinyurl.com/276964f)

<sup>xi</sup> Rooney, Ben. "Ford to add 1,200 workers in Chicago." CNNmoney. Jan. 26, 2010. Online here: [tinyurl.com/296vd9b](http://tinyurl.com/296vd9b).

<sup>xii</sup> Office of the State Auditor of Missouri, Susan Montee, 2010.

<sup>xiii</sup> "Findings in the audit of Tax Credit Cost Controls," Office of the State Auditor of Missouri, Susan Montee, 2010. Online here: [tinyurl.com/2fdkp7v](http://tinyurl.com/2fdkp7v)

<sup>xiv</sup> Enterprise Zone and Enhanced Enterprise Zone Tax Credit Programs, Office of the State Auditor of Missouri, Report No. 2010-106, Sept. 2010. Online here: [tinyurl.com/29ygp3](http://tinyurl.com/29ygp3)

<sup>xv</sup> This is also true in Michigan. Using the state cross-industry estimates from the Bureau of Labor Statistics website, I isolated the "motion picture and sound recording industries" category (NAICS code 512) for Missouri, from years 2002 to 2009. Using the 2002 Economic Census, I isolated this information for 1997. There were 4,143 people in Missouri employed in this category in 1997, and 3,949 in 2009. This means that more people were employed in the industry in Missouri before the state began offering targeted tax credits in 1998.

<sup>xvi</sup> Harbin, Christine. "Fewer Missourians Employed in Movie Industry Than Before Film Tax Credits Began." Show Me Daily. May 20, 2010. Online here: [tinyurl.com/2dh7j2d](http://tinyurl.com/2dh7j2d)

<sup>xvii</sup> The Mackinac review compared job promises made in press releases issued by Michigan's economic development agency, accompanying tax credit awards, to the actual outcomes of those programs.

<sup>xviii</sup> LaFaive, Michael D., and Michael Hicks, Ph.D., "MEGA: A Retrospective Assessment," Mackinac Center for Public Policy, April 2005. Online here: [tinyurl.com/26hgauw](http://tinyurl.com/26hgauw)

<sup>xix</sup> Niquette, Mark, "Some fall short of tax-credit promises," *The Columbus Dispatch*, July 11, 2010. Online here: [tinyurl.com/29nfkmm](http://tinyurl.com/29nfkmm)

<sup>xx</sup> LaFaive, Michael D., and Michael Hicks, Ph.D., "MEGA: A Retrospective Assessment," Mackinac Center for Public Policy, April 2005. Online here: [tinyurl.com/26hgauw](http://tinyurl.com/26hgauw)

<sup>xxi</sup> Basker, Emek. Labor-Market Effects of Wal-Mart Expansion, *Review of Economics and Statistics* 87:1 (February 2005) 174-183

<sup>xxii</sup> Haslag, Joseph, "Econ Matters: Do we really benefit from tax credits?" *Columbia Business Times*, Sept. 3, 2010. Online here: [tinyurl.com/2g8426b](http://tinyurl.com/2g8426b)

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<sup>xxiii</sup> For more information, see: Rothstein, Paul, and Nathan Wineinger, "Transferable Tax Credits in Missouri: An Analytical Review," *Regional Economic Development*, vol. 3, no. 2, 2007, pp. 53–74. Online here: [tinyurl.com/29xh22h](http://tinyurl.com/29xh22h) ; also see: "Review of the State Tax Credits Administered by the Department of Economic Development" Office of the State Auditor of Missouri, Claire McCaskill, 2001. Online here: [tinyurl.com/27m54jm](http://tinyurl.com/27m54jm)

<sup>xxiv</sup> Enterprise Zone and Enhanced Enterprise Zone Tax Credit Programs, Office of the State Auditor of Missouri, Report No. 2010-106, Sept. 2010. Online here: [tinyurl.com/29ypgp3](http://tinyurl.com/29ypgp3)

<sup>xxv</sup> Iowa has had difficulty with fraud in its filmmaker tax credit program, such as the purchase of luxury cars.